ETF Exchange Podcast Episode 14

Voiceover:

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Hello and welcome to the Fidelity ETF Exchange powered by Fidelity Connects, connecting you to the world of investing and helping you stay ahead. In the 14th episode of the Fidelity ETF Exchange, cohosts Etienne Joncas Bouchard, Katrina Wilson and Himesh Patel provide their insights on the state of the fixed-income ETF market. The panel dissect what truly happened during March 2020 in fixed-income markets. They also look at where we currently stand from an investable universe standpoint for bonds, the case for active versus passive fixed-income investing and more. Today's podcast was recorded on February 4, 2021.

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EJB: Hello, everyone, and welcome to the Fidelity ETF Exchange. I'm your host. Etienne Joncas Bouchard, also known as EJB. And as always, I'm joined by my co-host, Katrina Wilson, as well as our new contributor. And we were going to call HP our recurring guest, but let's brand him as a new co-host as well for the ETF exchange.

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EJB: In our last episode, the first of the year, we took 30 minutes to give you all an outlook for the year to come. So we explored some of the key trends to look out for in 2021, including the continued rise in ESG ETFs, a rotation from a factor's standpoint, from some of the more growthier momentum styles to quality and other factors that are a bit more cyclical, such as value and dividend. We also discussed industry flows from a management style standpoint, the old passive versus active debate. We also covered some subjects of what happened in 2020. So what were some of the key trends that had developed over the past year in/and impacted ETF markets as much as in Canada, in the U.S. as well, a majority of asset classes that may have been impacted by those changes.

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EJB: For today's episode, we're going to take a deep dive into the world of fixed-income ETFs. Other than March last year, when fixed-income ETFs were all the talk due to the mostly unfounded criticism of divergence between NAV prices and market prices during a period of obviously heightened volatility that we saw due to the covid-19 pandemic, I think most of the talk has been focused around equities just because, obviously from a flow standpoint, from a performance standpoint since March, obviously, most investors were rotating back towards equities to buy back more of a depressed asset.

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EJB: But I think it's time that we go back to the fixed-income discussion. And I'm really happy that we're going to be doing this as a committee because there's a lot of stuff to cover. And there's definitely some great questions that I'm looking forward to asking you guys and getting some of your insights on that. So as we head into 2021, many of you are probably asking yourselves, "how should I go about my fixed-income allocation in my portfolios?" Because regardless of where we find ourselves currently from an environment standpoint, in terms of yields, spreads, what does the investable landscape look like? There's definitely some opportunities out there, but there's also some things to consider, to watch out for. So I think it's a valid question to ask. And the first one I will be asking both of you is let's address the elephant in the room, which is what happened in March. What's the truth? What are some myths? And I guess what ensued from that and how did fixed-income ETF market behave following this dislocation price in NAV, in March. So Kat, maybe we can start with you.

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KW: Yeah, I think it was a bit of a shock. And the reality is the last time we saw that level of volatility was 2008, and the assets and fixed-income assets were significantly lower than where we are today. So it wasn't necessarily something new that happened, but obviously something that was much more prominent from an investor and advisor's perspective.

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KW: I think at the end of the day, what we have to think about is the idea that ETFs or Mark-To-Market and Bonds are traded over the counter. And so oftentimes we can make sure that the ETF keeps up with the trading of bonds. But in March, what happened was there is a shock to the fixed-income market.

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KW: And the analogy that I like to use is really talking about the housing market, because I think it's similar in the sense that you can get the price on a home at any point in time. But that doesn't necessarily mean that's what someone is paying today for that house. And so I really attribute it to the difference between if we think back to the discount that we saw on NAV in March, I use the analogy that let's say there's two houses side by side that are expected to be valued at the exact same.

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KW: One of the owners gets their house appraised, and the appraisal comes back at a million dollars. The other neighbour says, I'm not going to get an appraisal. I'm just going to list my house. And they get an offer for nine hundred thousand. Is the house worth nine hundred thousand or a million? Well, it could very well be worth a million, but maybe there's just something going on in the market that day, like a recession, which is what we saw in March, that just had a material impact on supply demand. So, a really important lesson. It held true across every fixed-income asset class, essentially. So I think that's an important note to make. It rectified itself extremely quickly, but certainly was a lesson in something to expect and to think about as an investor, an adviser. Anything to add?

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KW: Himesh, obviously, we were on the road or virtually at that point, but interested to see the questions you had and how those conversations went.

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HP: Well, maybe you should add a couple of zeros to that housing example, if you're looking at the Canadian market. But no, I totally agree. I think what really ensued was just a ton of uncertainty in the fixed-income market. And it was extremely unprecedented times, given that we hadn't really had something like this in the past where the fixed-income market pretty much was trading like it was an illiquid asset class, when in fact there's trillions and trillions of dollars around the world that are invested in this asset class that have institutions backing that bond market. But the ETF market simply was just pricing in what was happening in the distortion in the market, especially with the volatility that we saw. And like you said, it only took one day, two days maximum to correct itself. And so when you look back at the performance and the history, over one year, you will see that one- or two-day blip in the market. But essentially, it's not going to be a problem going forward because now we have central banks buying bonds. We have ample amounts of liquidity in the market which serve to be a backstop to this and to the asset class.

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EJB: I think that's a great point that you mentioned HP, with the central bank stepping in because when they saw there was liquidity, not issues in the fixed-income market. But yes, there was just less people buying and selling because the spreads were wider. And that was reflected in the actual market prices. And that's what market makers were taking into consideration. They were, in a sense, discovering the price of these baskets.

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EJB: They were saying if you were to sell everything in this basket right now, this is what it would be worth. And to Kat's analogy with the house, I think that's the best way to see it because what is it really worth? What somebody is willing to pay for it or what your valuation is from the municipality or whomever evaluated it. So I think in reality, it was more of a tool almost to see what was going on in the underlying bond market, something that was maybe neglected and that we had forgotten about. That actually could happen since the last time that there was somewhat of a divergence between prices and NAVs for fixed-income ETFs was in 2016, and then probably going back to 2008, 2009 when there weren't that many assets and fixed incomes, at the very least in Canada. So maybe it wasn't made out to be what it was in last March because of the number of assets that are in there.

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EJB: But regardless, and I really think that it showed the strength of the ETF vehicle because it got through this whole period and came out even stronger. And we saw it in terms of flows, recovery and just overall price recovery.

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KW: [I think something to make it, all great points.]

Another thing that's really interesting to see is where it really stood out probably the most was in passive strategies, because all of a sudden, you're actually paying attention to tracking there. In some cases, you saw an ETF underperformance tracked index by six percent, but we still saw flows going into passive strategies on the other side of that.

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KW: So to your point, I think we saw (audio cut out) and just fixed-income ETFs in general. So it obviously really showed the strength of the sort of liquidity that can be provided with an ETF despite that blip in the market. And I think it shows the investors' sort of awareness and understanding of these challenges.

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KW: I shouldn't say challenges.

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HP: Absolutely. And I think even another thing we can add is that it wasn't a vehicle issue. We were literally getting a glimpse into what was going on underneath was something that you didn't see through a mutual fund. But the manager was seeing it, the portfolio manager on the fund would be seeing that. And also, to your point Kat, the active versus passive debate is where an active manager, in order to maintain liquidity, can go out and sell their treasuries, which may be more like would use some of their cash for redemptions if need be. The ETF is obviously very liquid due to the intraday trading. So we need to price it at all times. There needs to be a bid in and ask and obviously reflecting conditions that were very difficult in the underlying market and not so much the ETF itself.

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KW: And maybe that's a perfect transition, as you said, kind of the benefit of active management.

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KW: Now let's talk about the other side of what happened in terms of the discount to NAV was the boom of new issuances in investment-grade corporates, which was a tremendous buying opportunity for active managers and not something passive strategies could participate in.

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EJB: One hundred percent.

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EJB: And it definitely created buying opportunities because you saw spreads widened to historical highs, and an active manager can obviously benefit from that.

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EJB: So I definitely want your take on this HP. What is some of the inherent risk with pure passive fixed-income ETFs because obviously those are the most popular still in the Canadian marketplace as well as the US marketplace. Are there any risks and how can some active managers mitigate those risks, but also to Kat's point, have the flexibility to take advantage of some possible opportunities that arise through either volatility or any other type of market movements?

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HP: Yeah, that's a really great point. I think one of the biggest issues with passive fixed-income investing is that interest rate risk is really out of control right now. If you look back at the last 10 to 15 years, even through the global financial crisis, the duration on these indices at its maximum back then was around six and a half years. Today, we're sitting at a duration of about eight point five, between eight to eight point five, maybe even nine in some cases. And so when you're looking at the aggregate bond universe, what essentially has happened over the last few years is companies, and rightfully so, have refinanced their debt to longer maturities because of the low interest rate environment. But now when you're investing in a passive fixed-income index or an ETF, you're not getting an eight-year duration risk with not a lot of yield that's being generated from their product. And so from an active perspective, I think it makes a lot of sense to, especially if you're trying to get a little bit of yield to offset that duration risk, to take an active approach in buying some of those other securities that can take a barbell approach, for example, or go into the shorter end of the market. I think another big theme is buying into the new investment-grade or high-yield bond issues.

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HP: And we saw that last year where the investment-grade bond market and the high-yield bond market were at record numbers in terms of new issuances. Just based on the fact that the Fed lowered rates so much that companies again were refinancing their debt, but still maintaining pretty attractive yields in this base. And so, if you're a passive fixed-income bond ETF, you can't really participate in those new issues until that index rebalances. And that typically happens at the end of the month. And even so, based on their method of tracking the index, it's either through a stratified sampling method or it's a quant approach. So you're not always getting the benefit of the new issue market. And then secondly, it's the forced buying and selling of passive ETFs as well, when an issue goes in and out of the index, you're forced to buy or sell it.

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HP: Whereas with the active approach, you can determine whether or not that meets the criteria of the ETF. And you can capture some alpha there as well.

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EBJ: To the new issuance point, which is a really good one, is when you think about it, if we look at the past 10, 15 years, generally speaking, we have a downward trend in interest rates and spreads have become tighter and tighter. And that also means that if you're buying, if a bond is issued on, say, today we are February 4th, and your rebalancing period is at the end of the month, generally speaking, you're buying it at a premium. If yields are going down. So over time, you're compounding this effect of continually buying bonds at a premium, so above par value. I think that's also one thing to note there for sure.

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KW: [And I think the only thing from my perspective that I would add, I think all great points.]

We definitely spend more time thinking about fixed income, even though it's maybe not as exciting as talking about what's happening with GameStop, but even just from a standpoint, if you look at the fixed-income market overall right now, as we hear active managers talking about there's no fat pitch/picks, so it might not be let's go all in with high-yield leveraged loans. But even just thinking about the yield curve, and I mean the fact that 20 to 30-year yield curve Canada-U.S. is essentially flat. And so, if you own a 30-year bond and a year from now, it's a 29-year bond, there's no change on the overall interest rate or the spreads. So you could really just have a bond stay kind of stagnant as it rolls down the curve. Yet, right now we've actually seen significant steepening at the short end of the curve. And so an active manager can say, well, I'm going to reallocate these 20-year bonds down to seven-year bonds, which touches exactly on what Himesh said. You can get barely reduction in yield, significantly lower duration, and you can actually capture the fact that it can roll down where it's really steep, which can lead to embedded capital gains. And I think right now, that's something longer managers are talking about. We're starting to see that being kind of the most attractive way to reduce duration in the portfolio. But again, not something, a passive strategy is just forced to own whatever people are issuing. So they're issuing a 20-year bond, even though that's not what you want to own, that's what you're going to own in the portfolio. So that's the only final comment I'd make in terms of active over passive at this stage of the market.

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HP: Yeah, and I think just to add to that. I don't think we're going to see the 6-7% return that we saw in aggregate bonds over the year of 2020. It's definitely going to be, like you said, Katrina, not a fat pitch and fixed income for sure, given where yields are, where spreads are. And so taking more of an active approach in your fixed-income book makes a ton of sense, I think, especially from a risk-return perspective.

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EJB: OK, we're maybe a little pessimistic here. There's got to be someplace where we can generate some decent returns on a relative basis in fixed income. And I think the word relatives takes on even more importance given where we are from a yield and a spread standpoint. So whether we look at investment-grade corporates, we look at, obviously government bond yields are very low. We're like in the bottom decile or even quartile for some spread sectors. I guess, what are we looking for? What should we be looking to allocate a little bit more exposure to, in favor or I guess, to the detriment of maybe more of the long-term government bonds that have done so well, especially considering that we're starting to see, obviously, some signs of an early cycle where yields are slowly rising, generally speaking. And also, you have inflation which is slowly creeping up on us, albeit very slowly. So are there some areas of the market that seem attractive on a relative basis? What are some of the ways that we can invest in those via ETFs? I'd like your thoughts on that guys.

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KW: So for me it's short and mid-term corporate bonds, I think government bonds, if you look historically, they look really attractive from a standpoint of negative correlation to equity markets. I just don't see how we have that going forward. If rates are so low that the sort of potential for monetary policy and the stand of the Bank of Canada to cut rates, which is why they have negative correlation to equity markets, I just don't think there's a strong case there. And so if you look at corporate bonds, specifically at the short end in Canada and the US, yields and spreads are pretty attractive. In Canada you have around 100 basis points. Option-adjusted spreads have spread over government bonds. With where yields are right now, that's a huge uptick. And as you mentioned, you might see yields slowly creeping up. At the end of the day, what is yield? Yield is a buffer against the rising interest rate environment. So if you can have the same duration be of one hundred basis point buffer, it gives you a little bit more capacity to see rates rising without seeing a negative return. And then lastly, as I mentioned, you do have that steeper on the curve. So from an active manager's perspective, if valuations are high, it might not be overly attractive to be actively trading in the market today. But what you can do is just buy bonds at one stage of the yield curve and let them roll down until something happens. So for me, like I said, I was excited talking about some stocks these days, but based on where yields are, based on the inherent interest rate risk, I really like the idea of cutting your duration and going short to medium-term corporate bonds.

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HP: I would echo that point as well. And I like that you pick that asset class in general because I'm a permeable. So I like to take a little bit more risk and I'm going to take the barbell, the other side of that barbell strategy and say go out on the risk spectrum and get into high-yield emerging markets debt because you're getting paid to own those securities without taking a lot of risk right now. And the reason I say that is because you're getting four and a half to six percent gross yield on U.S. high-yield bonds, global high-yield bonds and even emerging markets debt. But given where we are in the cycle, I think it makes sense that we can foresee pretty low defaults given where the economy is going now. We're seeing lots more optimism in the market with reopening and vaccine news. And so I think we can stay at these pretty tight levels of credit spreads and yields for the next foreseeable future, for the next one to two years, perhaps. And so in that environment, equities will do well, your short-term credit and your mid-term corporate bonds will help you mitigate some of that interest rate risk. But then if you're trying to attract some yield in your portfolio, go out on the risk credit spectrum and get into high yield in emerging markets debt where you're being paid to wait.

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EJB: I love both those ideas. And I think you can definitely accomplish exactly what you guys said. We still need to own bonds for downside protection. We still need it from a diversification standpoint. But in a scenario, to HP's point, where a default rate seems to have somewhat stopped going up, obviously through all the lockdowns, we had definitely an economic shock. If we're going to be in a good environment for equities over the next couple of years, definitely want to have something that's maybe a little bit more tied to the macro and the business cycle than taking on a lot of interest rate risk given where interest rates are and where yields are. So short end is good. Corporate bonds, high yield seems to be the common theme that is coming out of this. For somebody that would be maybe looking for an alternative, though, if you're saying I have enough fixed-income right now, I need something that's yielding four percent. So maybe high yield fits that bill. Are there any other asset classes that might come up or that you think, OK, well, for somebody that's maybe closer to retirement, maybe even for a portion of their equities, whereas in the past, if you were buying an aggregate bond index, you were getting a two to three percent yield, somebody looking for something around that for their portfolio. What might fit that bill?

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KW: I would stay in similar kind of storyline as high yield, but leverage loans, so leverage loans being floating-rate bonds. And so you often get with that yields that are more closely aligned with high yields, a little bit more cyclical. So don't expect them to be as sort of downside protection focus. But you mentioned that inflation creeping up, great way to hedge inflation in the portfolio. So because these bonds, they don't pay fixed, they pay floating-rate distributions, they're not sensitive to interest rates because they'll reset as the interest rate landscape changes. So I think that's a great diversifier in your portfolio. And yes, you're taking on a little bit of credit market risk, but you're really reducing the interest rate risk in a portfolio. So that's where I would go for a great yield enhancer.

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HP: I'm going to cheat and say dividend-paying equities.

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HP: Well, we all know they didn't do well last year, and we're seeing some of that catch up this year, but they're still pretty attractive from a yield perspective. So if you're able to afford some of that risk in your portfolio to get into dividend equities, then I think it makes a lot of sense from the yield perspective.

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EJB: All right. Well, absolutely. I think definitely that's a little cheap, but we'll take it. I think dividend equities, obviously, we talked about them a little bit last weekend and in our last episodes, but definitely offering a relatively attractive yield outlook. Another asset class that has done well over the past eight months, I guess since March is preferred shares. We don't talk about them too much. You know, it's either I feel like every time I'm talking to an advisor, it's either you love them, or you hate them. Is that something that you would consider in a portfolio allocation? To what extent should they be considered fixed income? I'll go out and just put my neck out there and say I don't think it should be compared to fixed income directly because of the correlation with equities and just overall volatility profile. But what's you guys take on that? I know often preferred shares come up a lot in Canada.

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KW: So I was actually thinking about this the other day, maybe I need a hobby if this is what I'm thinking about.

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KW: But I think what's happened is we've become accustomed to using the term fixed income and bonds interchangeably. So in theory, preferred shares they're fixed income. It is a fixed distribution. So I think because of that, they started getting bucketed with bonds because we started using the term fixed income to associate bonds. So from a portfolio construction standpoint, it was this is my equities, this is my fixed income.

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KW: So I think from that regard, it would make sense to put your preferred shares there. However, I totally agree. If you're thinking about the overall portfolio construction from an asset class standpoint and looking at bonds, I do think they should be associated with equities within the portfolio context.

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HP: Agreed. Preferred shares or equities.

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EJB: Perfect. All right. Well, that's a good wrap up. I didn't have any other questions set up. Is there something that you guys think our audience should be keeping an eye out for, whether that's from a flow standpoint, new products that are coming out, green bonds, maybe comments on that. Is there anything else you guys want to add before we wrap this up?

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KW: [I think for me, it's, and HP said it perfectly.]

We just have to reduce our expectation of returns for fixed income going forward, unfortunately. But it doesn't mean that you shouldn't own fixed income. And, hopefully we helped navigate some of the reasons why we're seeing passive money starting to rotate to active. Whether it be a completely open fixed-income mandate that does asset allocation as well, so you own your high yield, your leverage loans, your government bonds and whatever or if it's just taking advantage of individual mandates, like a short-term corporate bond, active mandate that can take advantage of new issuances, that can readjust where they're positioned on the yield curve. So certainly, we shouldn't move away from fixed income. But I do think now's the time to take a look at our fixed income and take into consideration what worked in the last decade might not work going forward, and it might be time to make some changes.

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Yeah, I'm going to echo that. I told every client that as well. Just make sure you're looking at your fixed income folks because we've experienced some pretty significant volatility, and that's probably going to continue into this year, even though it's to the upside, but we still need that diversification in your portfolio. You still need that active approach given where the opportunity is in fixed income. And I think the big message is obviously just continue to stay diversified. Fixed income is not an asset class that you should forget about. It's not a set and forget strategy either. And so maintain your active approach. Take a look at what you hold and continue to try and generate some yield out of that portion of your book.

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EJB: Well, that's great advice and thank you both for that. I think definitely fixed income might be a little bit less sexy than we mentioned earlier about whether it's GameStop or any other equities basically that you're looking at. It's still a very crucial portion of the overall portfolio for most investors.

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EJB: Obviously, we see people all the time invest 100 percent equities, and that can be fine depending on the risk they are willing to take.

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EJB: But for a long-term standpoint, you know, the old 60-40, do not forget that 40 percent of your portfolio.

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EJB: So with that, I think we're good for today's episode.

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EJB: Thank you all for joining in. Thank you, Kat. Thank you, HP. Look out for our next episode coming out soon. Once again, thank you.

Voiceover:

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Thanks again. See you next time.